

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
1866 RESTAURANT CORPORATION	:	DETERMINATION
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period December 1, 1980	:	
through February 29, 1984.	:	

Petitioner, 1866 Restaurant Corporation, 1866 Ralph Avenue, Brooklyn, New York 11234, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1980 through February 29, 1984 (File No. 801312).

A hearing was commenced before Brian L. Friedman, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on April 29, 1987 at 9:15 A.M. and continued to conclusion on July 21, 1987 at 10:00 A.M., with all briefs to be submitted by November 4, 1987. Petitioner appeared by Lawrence and Walsh, P.C. (Lawrence S. Lawrence, Esq., of counsel). The Division of Taxation appeared by John P. Dugan, Esq. (Kevin A. Cahill, Esq., of counsel).

ISSUES

I. Whether petitioner, the purchaser in a bulk sales transaction, is liable for sales tax determined to be due from the seller in accordance with the provisions of Tax Law § 1141(c).

II. If so, whether the Division of Taxation properly estimated the sales tax liability of the seller.

III. Whether the Division of Taxation properly determined that the dining car structure was not permanently affixed to and, therefore, not part of the real property sold to petitioner, thereby subjecting said structure to the bulk sales tax.

FINDINGS OF FACT

1. On April 12, 1984, the Division of Taxation issued to 1866 Restaurant Corporation ("petitioner") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due in the amount of \$381,404.31, plus penalty and interest, for a total amount due of \$466,590.37 for the period December 1, 1980 through February 29, 1984.

2. On January 6, 1984, petitioner purchased from Corina Realty Corporation (the "seller") a diner business known as "The Arch" which was located at 1866 Ralph Avenue, Brooklyn, New York.

3. On January 13, 1984, the Sales Tax Bureau of the Department of Taxation and Finance received from petitioner a Notification of Sale, Transfer or Assignment in Bulk which advised

that, on January 6, 1984, it had purchased the aforesaid diner business from the seller. The total sales price of the business was omitted, but the sales price of the furniture, fixtures, etc. was listed as \$55,000.00. Bulk sales tax in the amount of \$4,537.50 (\$55,000.00 x 8¼%) was paid on January 25, 1984.

4. On January 18, 1984, the Audit Division issued to petitioner a Notice of Claim to Purchaser which notified it of a possible claim for New York State and local sales and use taxes from the seller. The said Notice of Claim to Purchaser further stated that, in spite of any provisions contained in the sales contract, no distribution of funds or property, to the extent of the amount of the State's claim, could be made before the following conditions had been met:

(a) The State Tax Commission had determined the seller's liability, if any.

(b) Payment of such liability had been made to the State.

(c) The Central Sales Tax Section of the Audit Division had authorized the release of the funds or property.

5. On January 27, 1984, the Audit Division notified the seller that it would be contacted by the district office to make the necessary arrangements for an examination of its books and records.

6. On March 2, 1984, the seller executed a consent extending the period of limitation for assessment of sales and use taxes whereby it agreed that such taxes for the period December 1, 1980 through February 28, 1981 could be assessed at any time on or before June 20, 1984.

7. An audit of the seller's books and records was commenced in February 1984. Sales tax returns and related worksheets, Federal corporation income tax returns and State franchise tax reports with related worksheets, depreciation schedules, a cash receipts journal, a check disbursements journal, purchase invoices, cancelled checks, monthly bank statements and journal entry sheets were provided to the auditor. Guest checks, register tapes and day books were not made available. The seller's accountant, at the time of the audit, informed the auditor that he had requested and had received permission from the Department of Taxation and Finance to destroy the guest checks and register tapes prior to the commencement of the audit. No proof of such request or permission to destroy such records was produced herein.

8. The auditor visited the business premises. He observed that it was a 24 hour diner with a seating capacity of approximately 235 and that it employed 35 to 40 persons.

9. The auditor reconciled gross sales per books to gross sales per returns filed which were found to be substantially in agreement. The seller's income and franchise tax returns were also found to be in agreement with sales per books and sales tax returns. The auditor then examined the statement of closing of petitioner's purchase of the diner which revealed that, pursuant to such document, petitioner had obligated itself to annual rental payments of approximately \$84,000.00 (\$7,000.00 per month plus a cost of living increase equal to ½ of the fractional increase in the Consumer Price Index for the prior lease year above that in effect for the month of May 1983) and annual promissory note payments of approximately \$245,108.00. Based upon the unavailability of source documents, i.e., guest checks and register tapes, together with the auditor's conclusion that, based upon sales reported by the seller, petitioner would not be able to meet these payments, the auditor determined that an audit using external indices was proper herein.

10. Initially, the auditor sent letters to the seller's liquor and wine suppliers and to some of its main food suppliers in an attempt to confirm the seller's purchases. The replies received were "in general" and the auditor was, therefore, not able to match such replies completely with purchases set forth in the seller's books. While not all suppliers responded to the auditor's confirmation letters, the responses received generally corresponded to the purchases as set forth in the seller's records. As a result of his inability to perform a complete analysis of purchases, the auditor decided to use an audit method which employed a rent factor derived from Dun & Bradstreet, Inc. ("D & B"). The rent factor (4.93%), which represented the percentage of business receipts expended for rent, was calculated by D & B using a representative sample of the total of all Federal income tax returns filed by "eating and drinking" places for the period July 1976 through June 1977. The July 1976 through June 1977 D & B edition was utilized because it was the most recent edition available in the auditor's office. Additional taxable sales were calculated as follows:

Rent/year	\$ 84,000
D & B rent factor 100 divided by 4.93 =	<u>x 20.28</u>
	\$1,703,520
Divided by 4 quarters	
Gross sales per quarter	\$ 425,880
Number of quarters (12/1/80-1/6/84)	<u>x 12.5</u>
Gross/taxable sales	\$5,323,500
Less reported	<u>3,052,279</u>
Additional taxable sales	\$2,271,221

\$2,271,221.00 divided by 12.5 quarters = \$181,698.00 additional taxable sales per quarter

Based upon the rates in effect for the applicable periods, sales tax due on these additional taxable sales was determined to be \$186,013.05.

11. According to the statement of closing, the selling price of the business was \$2,350,000.00. Bulk sales tax was originally assessed on the entire selling price ($8\frac{1}{4}\%$ x \$2,350,000.00 = \$193,875.00). At the hearing, the Division of Taxation agreed that such tax should have been assessed only on the value of the furniture and fixtures (\$55,000.00) plus the value of the dining car structure (\$130,000.00). The bulk sales tax is, therefore, reduced from \$193,875.00 to \$15,262.50 ($8\frac{1}{4}\%$ x \$185,000.00). Since bulk sales tax in the amount of \$4,537.50 was previously remitted (see ___ Finding of Fact "3"), total bulk sales tax of \$10,725.00 remains at issue herein.

Additionally, the auditor examined the seller's recurring expenses for rubbish removal on which tax had not been paid. For the period at issue, expenses of \$15,214.00 were determined to have been incurred and tax due thereon was assessed in the amount of \$1,248.14. The auditor also disallowed certain fixed asset acquisitions totalling \$3,250.00 on which tax due was determined to be \$268.12. At the hearing, petitioner agreed to that portion of the assessment which related to recurring expenses and fixed asset acquisitions (\$1,248.14 + \$268.12 = \$1,516.26).

Inasmuch as petitioner has agreed to the tax assessed on the recurring expenses and fixed asset acquisitions (\$1,516.26) and the Division of Taxation has agreed to a reduction in bulk sales tax in the amount of \$178,612.50 (\$193,875.00 - \$15,262.50), the total amount of tax remaining at issue herein is reduced to \$201,275.55 which amount represents sales tax assessed

on additional taxable sales, which were determined by the auditor by means of the D & B rent factor (\$190,550.55), plus bulk sales tax remaining at issue (\$10,725.00).

12. A prior audit of the seller's business for the period September 1, 1976 through May 31, 1979 resulted in an assessment in the amount of \$459.00 which represented an overcollection which had not been remitted to the Department of Taxation and Finance.

13. The auditor did not analyze the cash flow of petitioner to determine whether or not its rental and promissory note obligations could be met. While the sale of the business did not occur until January 6, 1984, petitioner operated the business from May 1983. Although the D & B rent factor was applied to determine the seller's additional taxable sales, it must be noted that the seller paid no rent during the period at issue. For the fiscal years at issue herein, the seller reported sales as follows:

<u>Fiscal Year Ended</u>	<u>Sales Per Federal Returns</u>	<u>% Increase</u>
6/30/81	\$863,151.79	
6/30/82	\$918,566.17	6.42
6/30/83	\$986,391.24	7.38

The D & B edition for the fiscal year July 1982 through June 1983, while not issued until 1986, indicated a rent factor for the aforesaid period of 5.78 percent. It must further be noted that the term of the lease (\$7,000.00 per month plus a cost of living increase based on a fraction of the Consumer Price Index) was for 35 years or until April 30, 2018. The lease was "front-loaded", i.e., it was designed to allow the lessor to realize a large return early in the period due to the uncertainty of its receiving a reasonable return in the later years of the lease. On page 4 of the statement of closing is contained the following language:

"Premises: The land only at 1866 Ralph Avenue, Brooklyn, New York. (Please note that the diner is considered personal property and not part of the real estate.)"

SUMMARY OF PETITIONER'S POSITION

14. (a) Since there were no discrepancies or inaccuracies in any of the documents produced by the seller or petitioner, it was inappropriate and unreasonable for the Division of Taxation to rely on external indices to perform the audit herein.

(b) It was unreasonable for the Division of Taxation to estimate additional sales tax due by utilizing the D & B rent factor, especially in light of the fact that no rent was paid for most of the audit period. Furthermore, the Division of Taxation offered no evidence to show that the D & B rent factor was calculated from the returns of similar businesses in similar locations.

(c) The dining car structure is part of and is permanently attached to the real property and, as such, is not properly subject to the bulk sales tax.

CONCLUSIONS OF LAW

A. Petitioner has neither alleged nor proven that it complied with the provisions of Tax Law § 1141(c) and, since failure to comply therewith results in liability of the purchaser for taxes

which the State claims to be due from the seller, it is hereby determined that petitioner did not comply with said provisions and is, therefore, liable for taxes due from the seller herein.

B. Tax Law § 1138(a) provides, in pertinent part, that if a return required by Article 28 is not filed or, if a return when filed is incorrect or insufficient, the amount of tax due shall be determined from such information as may be available. If necessary, the tax may be estimated on the basis of external indices.

In *Matter of Christ Cella, Inc. v. State Tax Commn.* (102 AD2d 352, 353), the Appellate Division, Third Department, stated as follows:

"The department, however, may not use such external indices unless it is 'virtually impossible to verify taxable sales receipts and conduct a complete audit' with available records (*Matter of Chartair, Inc. v. State Tax Commn.*, 65 AD2d 44, 46; see, also, *Matter of Korba v. New York State Tax Commn.*, 84 AD2d 655, *mot for lv to app den* 56 NY2d 502)."

Due to the failure of the seller to produce guest checks and register tapes (source documents), the auditor was unable to verify the accuracy of the seller's books and records and of its sales tax returns filed for the audit period. His resort to external indices to conduct his audit was, therefore, proper.

C. In determining the amount of a sales tax assessment, it is the duty of the Audit Division to select a method "reasonably calculated to reflect the taxes due" (*Matter of Grant Co. v. Joseph*, 2 NY2d 196, 206)". (*Matter of Meyer v. State Tax Commn.*, 61 AD2d 223, 227, *lv denied* 44 NY2d 645.)

The D & B rent factor was calculated by D & B from what it categorized as a representative sample of the total of all Federal income tax returns filed for 1976-77 by "eating and drinking places". The term "eating and drinking places", on its face, encompasses bars, fast food restaurants, etc.

In *Matter of Grecian Square, Inc. v. New York State Tax Commn.* (119 AD2d 948), a matter which involved the audit of a bar in Astoria, New York, the auditor estimated sales by calling upon his experience in auditing bars. The Court stated that where petitioner's records were unreliable and incomplete, it was proper to resort to external indices. However, the Court remitted the matter to the Commission, stating that "without some information about the size, location, number of employees and nature of the operation, this court is unable to make a determination as to the existence of a rational basis" (*Matter of Grecian Square, Inc. v. New York State Tax Commn.*, *supra*, at 950). The auditor in the present matter visited the premises and possessed information concerning the operation of this particular business. Moreover, at the time of the audit, petitioner was operating the business in the identical manner that the seller had during the period at issue. Yet the auditor, while entitled to utilize an external index by virtue of the lack of source documents, chose a very general external index which clearly did not take into consideration the particular size, location and nature of the business.

The D & B rent factor utilized herein was calculated for the fiscal year 1976-77, a period which was more than three years prior to the audit period. While the evidence has shown that the D & B edition for the last complete fiscal year at issue (1983) was not available to the auditor at the time of the audit, it can be presumed that an edition later than 1976-77 existed and the

auditor's explanation that the 1976-77 edition was the latest available in his office is, nonetheless, inexcusable.

The evidence is indisputable that the seller owned the business premises and did not pay any rent during its operation of the Arch Diner. It is, therefore, unreasonable to estimate the seller's sales by applying such a rent factor, i.e., to determine that its sales were not sufficient to justify an annual rent of \$84,000.00. No evidence has been produced to indicate that the auditor made any attempt to analyze either the seller's or petitioner's cash flow to ascertain whether or not an annual rental of \$84,000.00 was unreasonable. This is especially true in light of the fact that, for the fiscal years at issue, sales increased each year (see Finding of Fact "13"). Moreover, the lease was front-loaded which fact, when taken together with increasing sales, would indicate that, while petitioner may have initially incurred cash flow difficulties, it could reasonably have expected, within a short period of time, to generate sales which would justify its rental obligations.

It must, therefore, be determined that the use of the D & B rent factor for the fiscal year 1976-77 to determine additional sales tax due from the seller which, pursuant to Tax Law § 1141(c), have become the liability of the petitioner, is not a method which resulted in a reasonable calculation of taxes due. That portion of the assessment representing sales tax assessed on additional taxable sales determined through the utilization of the D & B rent factor (\$190,550.55) must be cancelled.

D. 20 NYCRR 537.0(g) provides, in pertinent part, as follows:

"The sales tax is imposed upon the receipts from the transfer of all tangible personal property from the seller to the purchaser which is included in the property sold in bulk, except property sold for resale as such and except the tangible personal property which is exempt from the tax. The tax is not imposed on real property or on intangible personal property such as good will or accounts receivable."

Petitioner contends that the dining car structure was permanently affixed to the realty and, as such, must be considered to be real property which is not subject to the bulk sales tax. However, as indicated in Finding of Fact "12", supra, the statement of closing clearly indicated that the dining car structure was to be considered personal property and not part of the real estate. The balance of the bulk sales tax at issue, after reduction from the original amount assessed (\$193,875.00) to \$15,262.50 and after credit for payments made (\$4,537.50), i.e., \$10,725.00, is, therefore, sustained in full.

E. The petition of 1866 Restaurant Corporation is granted to the extent indicated in Conclusions of Law "C" and "D", supra; the Division of Taxation is directed to modify the Notice of Determination and Demand for Payment of Sales and Use Taxes Due issued April 12, 1984 accordingly; and, except as so granted, the petition is in all other respects denied.

DATED: Albany, New York
September 1, 1988

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE